

# Solaris Core Australian Equity Fund

(APIR: WHT0012AU)

## Quarterly Investment Report as at 30 September 2022

### Market and Fund Performance

The S&P/ASX200 Accumulation index fell -6.2% over September, largely erasing the gains from July and August to finish the quarter up +0.4%. Global markets corrected sharply over the quarter, with the S&P500 (-5.3%), the MSCI World ex Australia Index (-6.5%) and the MSCI Asia Pacific ex Japan Index (-13.6%) responding to the aggressive and coordinated hiking cycle of global central banks. Most major central banks raised cash rates during the quarter, including the US Federal Reserve, Bank of England, and the Reserve Bank of Australia and guided to higher cash rates for longer in a commitment to fight inflation. Market volatility was further exacerbated by the UK's 'mini-budget', with unfunded tax cuts resulting in a significant sell-off in UK Government Bonds which prompted intervention from the Bank of England. Global bond yields reach their highest levels since pre-financial crisis, with the United States 10-year government bond reaching a high of 4.00% during the month and the Australian 10 year government bond reaching a high of 4.13%.

The top three constituent performers in the Index over the quarter included Pilbara Minerals (+99.1%) which outperformed along with all lithium miners and was buoyed by a successful Battery Material Exchange (BMX) auction. Whitehaven Coal (+95.6%) surged as profitability increased, driven by the considerable moves in thermal coal prices and Life360 (+87.3%) performed strongly when the interim result demonstrated strength of the Life360 application. The bottom three performers included EML Payments (-24.0%) which is undertaking a strategic review amid discovery of fraudulent activity, Domino's Pizza (-23.4%) which underperformed during the quarter due to the impacts of inflation and Novonix (-22.8%) was impacted by the de-rating of high growth segments of the market over the quarter.

A portfolio holding in focus over the month is IGO, an exploration and mining company focused on future-facing metals and the energy transition. IGO has performed strongly recently as the market has gained greater conviction on the outlook for lithium prices. Electric vehicle penetration rates, particularly in China, have been performing very strongly and have been assisted by favourable government policy. The company has exposure to the world's best hard rock lithium project, Greenbushes. The mine produces spodumene, a 6% grade lithium product with the highest mine head grade of any operating mine globally and also has the lowest cost of production. We are attracted to the company's strong growth pipeline, low cost of production, long asset life and the assets are located in tier one mining jurisdiction, Australia. The company plans to become fully integrated in lithium and is building and ramping up battery grade lithium plants in Kwinana, South of Perth. The plants will process the 6% lithium from Greenbushes and convert it into lithium hydroxide, a battery grade lithium product with a lithium content greater than 99%. The company also has grand ambitions in their nickel business, with the recent takeover of nickel producer, Western Areas completed in June. Nickel is also leveraged to the electrical vehicle thematic as EV batteries require the high-grade nickel to provide stability in the battery. The company has a strong balance sheet and strong free cash flow over the next few years given our expectation that lithium prices will remain well above our long-term price forecasts.

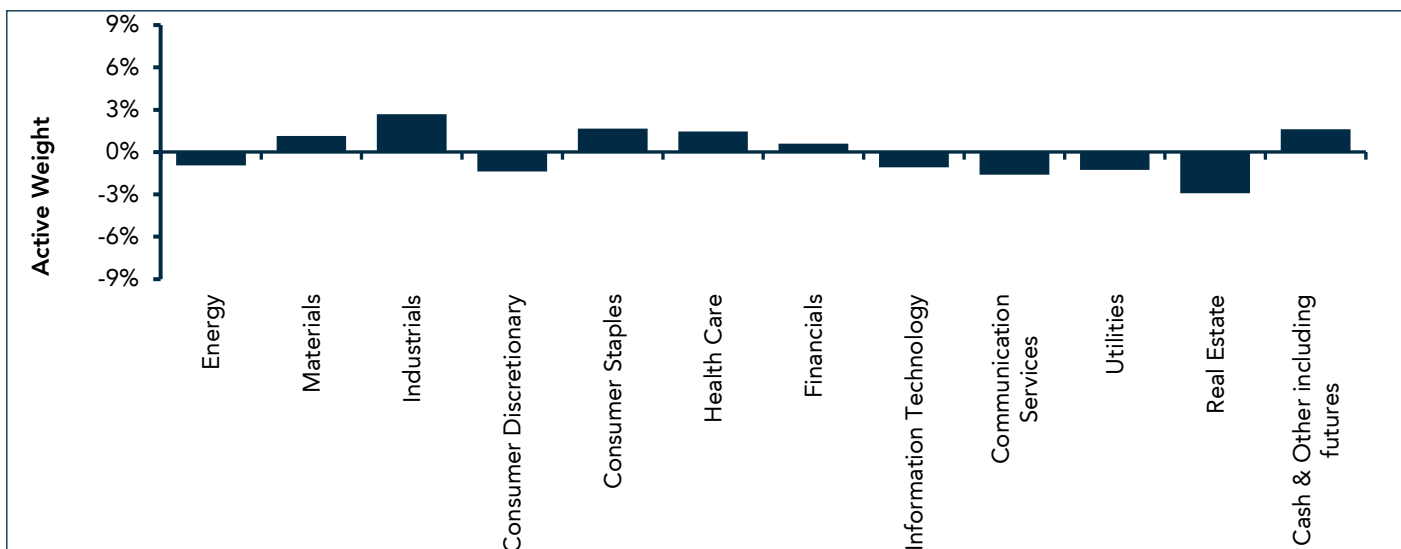
Returns	Month	Rolling Quarter	FYTD	1 Year	3 Years p.a.	5 Years p.a.	7 Years p.a.	10 Years p.a.	Inception p.a. (17/09/2008)
Fund Gross Return <sup>^</sup>	-6.01%	0.97%	0.97%	-6.36%	1.68%	6.65%	8.43%	9.66%	7.84%
Benchmark Return <sup>*</sup>	-6.17%	0.39%	0.39%	-7.69%	2.67%	6.76%	8.01%	8.41%	6.76%
<b>Active Return</b>	<b>0.16%</b>	<b>0.58%</b>	<b>0.58%</b>	<b>1.33%</b>	<b>-0.99%</b>	<b>-0.11%</b>	<b>0.42%</b>	<b>1.25%</b>	<b>1.08%</b>
Fund Net Return <sup>^</sup>	-6.08%	0.72%	0.72%	-7.25%	0.71%	5.63%	7.39%	8.61%	6.82%
Benchmark Return <sup>*</sup>	-6.17%	0.39%	0.39%	-7.69%	2.67%	6.76%	8.01%	8.41%	6.76%
<b>Active Return (After fees)</b>	<b>0.09%</b>	<b>0.33%</b>	<b>0.33%</b>	<b>0.44%</b>	<b>-1.96%</b>	<b>-1.13%</b>	<b>-0.62%</b>	<b>0.20%</b>	<b>0.06%</b>

<sup>^</sup> Performance is for the Solaris Core Australian Equity Fund (APIR: WHT0012AU), also referred to as Class B units, and is based on month end prices before tax. Net performance is calculated after management fees and operating costs, excluding taxation. Gross performance is stated excluding all fees, costs and taxation. This is historical performance data. It should be noted the value of an investment can rise and fall and past performance is not indicative of future performance. All p.a. returns are annualised. <sup>\*</sup> Benchmark refers to the S&P/ASX 200 Accumulation Index.

## Top 10 Stocks (Alphabetical Order)

Name	Sector
Australia and New Zealand Banking Group Limited	Financials
BHP Group Limited	Materials
Coles Group Limited	Consumer Staples
Commonwealth Bank of Australia	Financials
CSL Limited	Health Care
Macquarie Group Limited	Financials
National Australia Bank Limited	Financials
Westpac Banking Corporation	Financials
Woodside Energy Group Limited	Energy
Woolworths Group Limited	Consumer Staples

## Sector Allocation



Source: Solaris Investment Management, September 2022

## Market Valuation & Earnings Estimates:

	Market & Sector EPS Growth			Market & Sector PEs			Market & Sector Dividend Yield		
	FY22E	FY23E	FY24E	FY22E	FY23E	FY24E	FY22E	FY23E	FY24E
Pro-rated to June									
All Companies	19.0%	1.4%	-2.3%	13.4x	13.1x	13.4x	4.8%	4.8%	4.8%
Banks	13.9%	9.9%	0.5%	13.4x	12.2x	12.1x	5.1%	5.5%	5.8%
Listed Property Trusts	13.8%	-2.0%	5.4%	12.8x	13.1x	12.4x	5.4%	5.5%	5.7%
Resources	26.9%	-10.7%	-14.5%	6.9x	7.7x	9.0x	8.9%	7.6%	6.5%
Industrials ex-Banks	13.5%	11.6%	9.0%	21.5x	19.3x	17.8x	3.1%	3.4%	3.6%

Estimate only, which may not be realised in the future.

The securities presented on this slide are for illustrative purposes only and are not the complete holdings of the fund. Illustrative only and not a recommendation to buy or sell any particular security.

## Market Outlook

Fear and volatility are clearly in the driver's seat thanks to the combination of post-pandemic global inflation, rising interest rates, geopolitical concerns, and the growing risk of central bank policy error. None of these events were a focus last year – a stark reminder of how quickly circumstances can change. We have discussed in previous commentaries areas of the market that we believe warrant extreme caution. As we progress through this cycle at warp speed, many of these risks we have anticipated have quickly become a reality and are a clear focal point for investors. Namely:

### ➤ *Highly indebted companies*

The RBA has raised cash rates 2.50% in six rate hikes over the year to date, bringing the current cash rate to 2.60%. Concurrently, credit spreads have moved wider, dramatically increasing the cost of debt for many corporates looking forward. Balance sheet strength is a key pillar of our investment framework at Solaris and at the start of 2022 we placed a greater emphasis on balance sheet strength – assessing the levels of gearing, the levels of fixed versus floating debt and forward-looking interest coverage ratios across our portfolio companies. The portfolio has been positioned underweight the Real Estate and Utilities sectors, where the sharp rising cost of debt (both fixed and floating rate) is presenting a strong headwind, heightened risks to corporate funding structures and is the driver of earnings downgrades for individual companies that employ high levels of debt.

### ➤ *Discretionary retail*

To date, the Australian consumer has remained resilient, benefitting from the tailwind of residual COVID stimulus and pent-up demand as the consumer emerges from lockdowns. We anticipate a slowdown ahead as cash rate hikes begin to impact household budgets as the cost of variable rate mortgages increases, as fixed-rate mortgages roll off onto higher variable rates in 2023, as negative wealth effects from falling house prices impact spending intentions, as consumer confidence remains subdued and as household savings buffers are rundown. We are yet to see a deterioration in revenue however profit margins are beginning to be impacted, and given current elevated inventories across many retail stocks, we believe continued caution is warranted. A broad theme that we are seeing for retailers (and a range of other companies) is the pervasiveness of elevated inventory levels, suggesting earnings risks are elevated. A simple analysis of current inventory levels versus 2019 revenues (a more normalised level of sales activity) highlights inventory to normalised sales ratios at record high levels for several discretionary retailers. For these reasons, we are underweight the consumer discretionary sector, however, we are seeing opportunities for outperformance within the consumer staples sector where we see resilient earnings and pricing power.

### ➤ *COVID winners*

We have warned about the extreme concentration of capital invested in some COVID winners, such as healthcare, consumer credit, online retailing and IT and that investors were capitalising unrealistic valuations. Several companies in this category benefitted greatly from the work-from-home dynamic, a pull forward in earnings and artificially low rates and in many cases became irrationally priced – with market participants placing peak valuation multiples on what we viewed as the cyclical peak in earnings. As the environment normalises so have share prices. In this market, it is refreshing to see that valuations and earnings both matter again. It should be noted that many of the 'COVID winners' are quality businesses that had simply become overpriced, however, with the retreat in valuation multiples, it should be no surprise that some are beginning to look attractive.

### ➤ *Speculative loss-making firms*

As investors shift towards focusing on cash generation and operating leverage, this has driven a material correction in long-duration growth stocks. We believe the backdrop for the speculative segment of the market continues to be challenged given valuations remain elevated compared to their long-term history and that the cost of equity and debt markets are now material impediments.

We have been cautious these areas of the market for some time, and not owning companies exposed to these pressures has been a material source of alpha over the last twelve months. While we have taken profits and reduced underweight positions in some of these areas, we strongly believe caution and vigilance is still required. Balance sheet strength in particular should not be compromised in this environment.

## Market Outlook continued

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While short-term risks remain high, it is not all doom and gloom and a source of comfort is that investor sentiment and positioning is very negative, providing reassurance that investors are anticipating further bad news. It's important to remember that the stock market is a forward-looking indicator and has demonstrated a remarkable ability to anticipate better news ahead, even when market sentiment is at its most pessimistic.

While we certainly make no bold predictions about when this bear market will end, we do know that at some stage it will end (like all crises do), and most likely, it will be when investors least suspect it. With this in mind, we believe the below quote is particularly relevant:

*"You make most of your money in a bear market, you just don't realise it at the time" – Shelby Davis*

Without question bear markets can be unnerving however, for patient long-term investors they can also provide outstanding investment opportunities.

We have used the pullback and volatility over this year to add to several of our high-conviction positions at compelling prices. In addition, we have used indiscriminate selling to selectively add new positions in high-quality businesses that we believe are showing attractive valuations, in many cases for the first time in many years. In a similar vein to March 2020, we believe that looking through the short-term noise will prove to be the best decision for our client's medium and long-term interests.

We reiterate the importance of keeping an open mind, listening to what the investment landscape tells us, and staying nimble. We are in a rapidly evolving, uncharted economic environment and continue to expect significant volatility as central banks are stuck between fighting inflation but also ensuring financial stability. Investors need to consider investment managers with experience investing capital in these challenging environments. The upcoming US reporting season and domestic AGM season, which commences in October, will be a key focus for investors. We anticipate trading updates to carry significant weight and will likely result in increased volatility and opportunities for alpha generation.

Solaris aims to ensure that the majority of the risk in the fund is generated from bottom-up stock decisions rather than allowing macro events to dictate risk and performance. Through our portfolio construction and robust risk management, which is embedded in our +20-year process, we are confident in our objective and seek to offer higher potential returns across all market conditions.

We are seeing clear investment opportunities across many areas of the market and believe this elevated volatility is well-suited to the Solaris investment process. As always, thank you for your support and for allowing us the privilege of managing your investments.

Solaris Team.

Source: Solaris Investment Management, September 2022

## Contact Details

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Link to the [Product Disclosure Statement](#)

Link to the [Target Market Determination](#)

For historic TMD's please contact Pinnacle client service Phone 1300 010 311 or Email [service@pinnacleinvestment.com](mailto:service@pinnacleinvestment.com)

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